The German economy

Macroeconomic situation

German GDP shrank in Q4 2023

German economic output shrank in the fourth quarter of 2023. According to the Federal Statistical Office's flash estimate, real gross domestic product (GDP) fell by a seasonally adjusted 0.3% on the quarter after virtually stagnating in the first three quarters.[1] Industry continued to be impacted by weak foreign demand. Higher funding costs remained a drag on investment and thus on domestic demand for industrial goods and construction work. Moreover, uncertainty about climate and transformation policy is likely to have dampened investment. In addition, inclement weather constrained construction activity. Further pressure was placed on economic activity by the relatively high sickness rate. By contrast, lower inflation, the robust labour market and strong wage growth supported real private consumption. However, consumers probably remained cautious in their expenditure.

Economic activity in detail

Weak demand for industrial goods reflected in production and exports

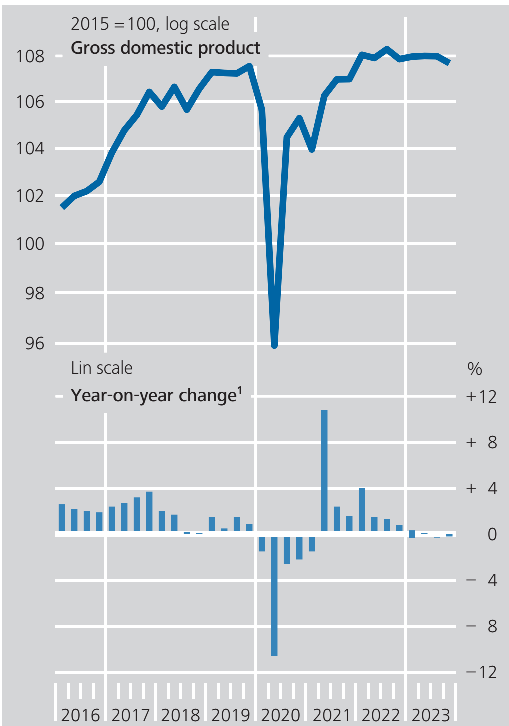
Seasonally adjusted industrial output declined significantly in the fourth quarter of 2023. The decline affected most sectors, except for the manufacture of motor vehicles and other transport equipment. Order intake has been weak for some time now, and is likely to be a notable factor increasingly impacting on output. Surveys by the ifo Institute show that the share of manufacturing firms reporting a shortage of orders has risen steadily since April 2023, reaching 37% at the end of the period under review. By contrast, supply bottlenecks continued to ease according to ifo surveys. Weak foreign demand was also reflected in real exports of goods, which declined further in the fourth quarter.

Higher financing costs and end of environmental bonus dampened business investment in machinery and equipment

Higher financing costs remained a drag on investment. Business investment in machinery and equipment is likely to have fallen significantly in the fourth quarter, as signalled by the steep decline in the price-adjusted sales of capital goods producers in Germany. Real imports of capital goods also saw a sharp drop. Enterprises invested less in their vehicle fleets. According to data from the German Association of the Automotive Industry (VDA), commercial passenger car registrations were down considerably. One factor that is likely to have played a role in this was the end of the environmental bonus for commercial owners at the end of August 2023.

Aggregate output

Adjusted for price, seasonal and calendar effects

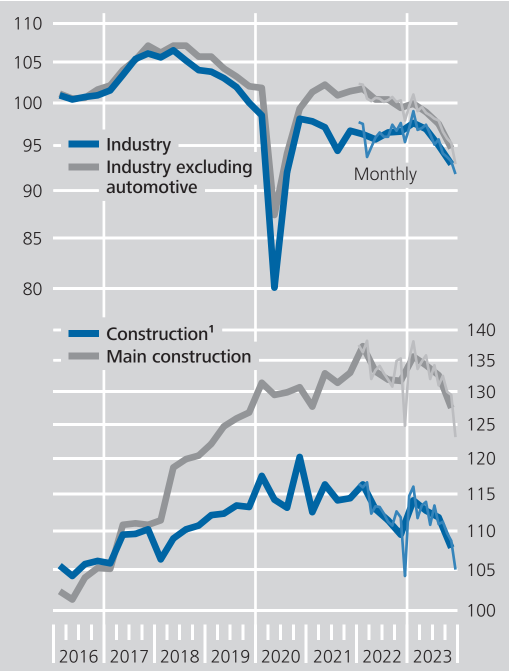


Source of unadjusted figures: Federal Statistical Office. **1** Price and calendar adjusted.
Deutsche Bundesbank

1 Seasonal adjustment here and in the remainder of this text also includes adjustment for calendar variations, provided they can be verified and quantified. The flash estimate also included some revisions for previous quarters.

Output in industry and in construction

2015 = 100, seasonally and calendar adjusted, quarterly data, log scale



Source of unadjusted figures: Federal Statistical Office. **1** Main construction sector and finishing trades.
Deutsche Bundesbank

Higher interest rates and inclement weather weighed on construction output and construction investment

Construction investment probably declined significantly in the fourth quarter. Seasonally adjusted construction output was substantially lower on the quarter, both in the main construction sector and in the finishing trades. Higher interest rates continued to weigh on demand for construction work. Averaged over October and November, order intake in the main construction sector saw a substantial drop compared with the previous quarter, leaving it 17% down on its level in the fourth quarter of 2021. According to ifo Institute surveys, the share of firms in the main construction sector reporting a shortage of orders continued to rise significantly in the last three months of the year. In addition, the high levels of precipitation are likely to have adversely affected construction activity.[2] Surveys conducted by the ifo Institute show that one-quarter of firms in the main construction sector reported that construction activity was hampered by weather conditions in the final quarter.

Private consumption and activity in services sector weak

Private consumption is likely to have registered a slight increase in the fourth quarter. However, despite lower inflation, the robust labour market and substantial wage growth, households remained cautious with their consumer spending. According to the market research institution GfK, consumers were unsettled by the geopolitical crises and conflicts, sharp rises in food prices and the debate about the government budget.[3] Price-adjusted sales in the retail sector once again declined somewhat. They were also down in the accommodation and food services sector, according to data available up to November. By contrast, households probably purchased considerably more cars, as indicated by private car registrations, which picked up substantially according to data provided by the German Association of the Automotive Industry. Meanwhile, activity in the services sector may have declined in the fourth quarter. According to data available up to November, services production (excluding trade) decreased. Trade in motor vehicles was probably also down. This is signalled by overall motor vehicle registrations, which declined markedly. The steep drop in commercial registrations outweighed the increase in private registrations. Real wholesale sales also decreased, probably partly in reflection of the weak industrial activity.

Labour market

Employment and unemployment both up slightly in Q4

The protracted bout of weakness in the economy has had only a mild impact on the labour market so far. Despite a decline in economic output, employment increased slightly in the fourth quarter. While unemployment reached a somewhat higher level than in the third quarter, the increase likely came to an end in the past two months. The number of job vacancies also stabilised recently, following an earlier decline. The same applies to most leading indica-

2 The fourth quarter of 2023 saw exceptional levels of rainfall. See Deutscher Wetterdienst (2024).
3 See GfK (2023).

tors of the labour market. Thus, there are no signs that the weak economy will imminently cause the labour market to worsen noticeably. Nor are there any signs of a significant rise in employment and a concomitant decline in unemployment from its slightly elevated level.

Employment growth in some services sectors offset decline in manufacturing and trade

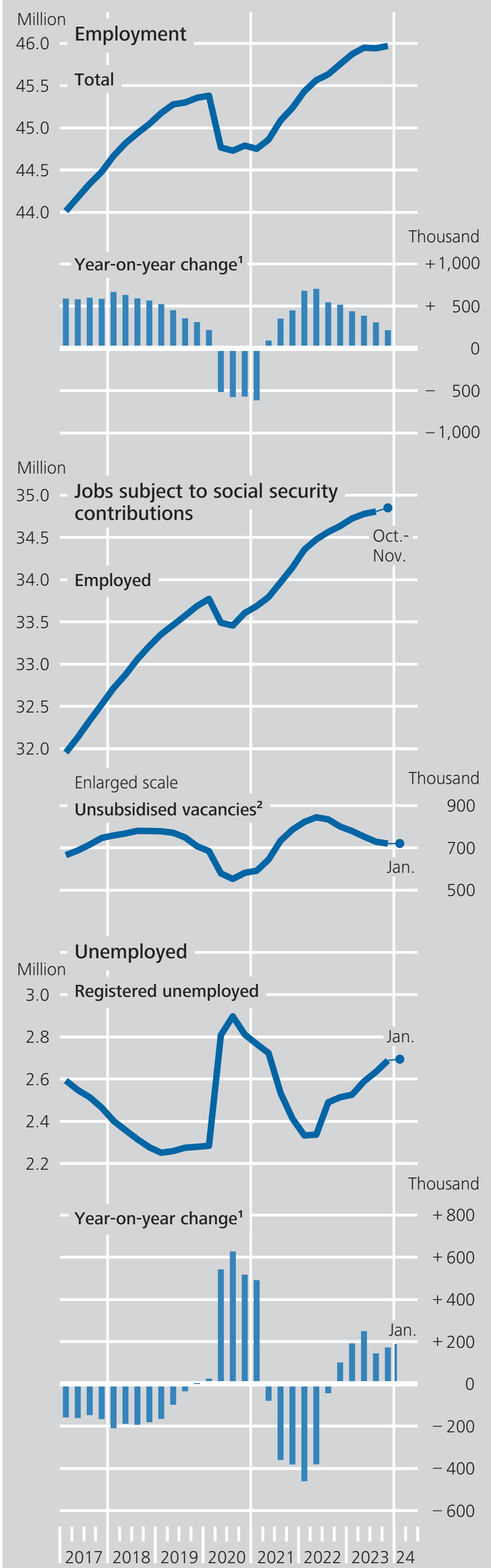
After the third quarter saw total employment stagnate, seasonally adjusted employment increased marginally in the final quarter of 2023, by 28,000 persons or +0.1%. There were declines in self-employment and exclusively low-paid part-time employment, contrasting with an increase in the number of jobs subject to social security contributions. According to the Federal Employment Agency's initial estimates, which cover the period up to November, staff levels are still going up in areas of basic public services – human health and social work, the public sector, energy and water supply, and education and training. Fairly positive developments were also seen in employment among qualified business service providers and in transportation and storage. Negative cyclical factors pushed down the number of temporary agency workers and of retail and wholesale staff slightly. The manufacturing and construction sectors saw a minimal dip in employment. Short-time work for economic reasons remained at its slightly elevated level. However, registrations for short-time work give no indication of a distinct increase over the next few months.

Further slight uptick in unemployment

Registered unemployment saw a slight uptick in the fourth quarter of 2023 as well. Looking at the quarterly average, the Federal Employment Agency recorded around 55,000 more persons as unemployed compared with the previous quarter, giving a seasonally adjusted total of 2.69 million persons. The unemployment rate climbed by 0.1 percentage point from the third quarter, to 5.8%. In January, unemployment remained virtually unchanged, as was the case in December. This was primarily due to an improvement on previous months in the number of unemployed people covered by the statutory unemployment insurance scheme, which is affected by cyclical developments.

Labour market

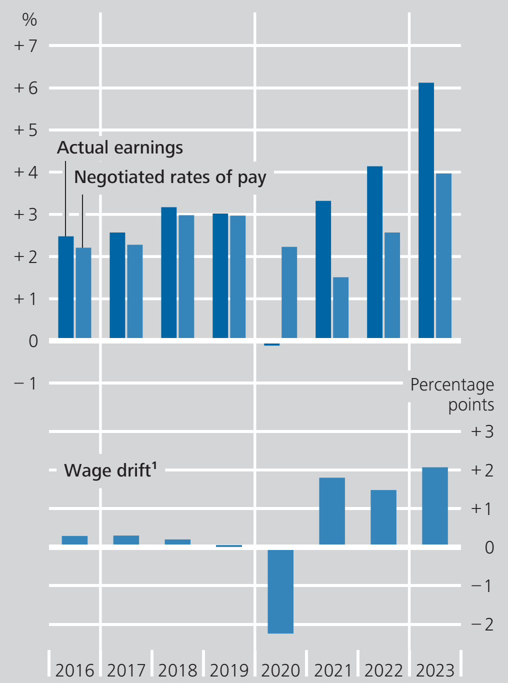
Seasonally adjusted, quarterly data



Sources of unadjusted figures: Federal Statistical Office and Federal Employment Agency. **1** Not seasonally adjusted. **2** Excluding seasonal jobs.
Deutsche Bundesbank

Rates of pay and wage drift

Year-on-year change, on monthly basis



Sources: Federal Statistical Office (actual earnings) and Deutsche Bundesbank (negotiated rates of pay). **1** Wage drift is calculated as the annual change in the ratio of actual earnings to negotiated rates of pay.
Deutsche Bundesbank

However, it would be premature to read this as good news for the economy, as weather conditions may also have played a role in December and January especially.

Most leading indicators of employment showing first tentative signs of improvement

The majority of leading indicators improved slightly in December and January. This suggests they have bottomed out after the labour market outlook had deteriorated somewhat in the course of 2023. However, this does not yet indicate that a wave of recruitment is imminent. The seasonally adjusted number of reported vacancies rose somewhat in December and January, marking the end of a slight decline spanning roughly 18 months in what remains a fairly high number of vacancies. In particular, the Federal Employment Agency has recently received more new job ads. It still takes a very long time for a vacancy to be filled. The employment barometer of the Institute for Employment Research (IAB) for the economy as a whole remains in positive territory and improved a little. For this barometer, the IAB surveys regional heads of the employment agencies about the local outlook over the next three months. This also includes employment developments in the services sectors benefiting from structural change, such as health and education. However, the indicator of recruitment plans in trade and industry – which are more exposed to cyclical fluctuations – for the next three months, as derived from the ifo Institute's monthly survey of around 9,000 enterprises, shows a negative balance and deteriorated further in January.

Number of unemployed unlikely to see any further significant rise

The dynamics of future unemployment, as reflected in the transitions between unemployment and employment, improved in January for the first time in 18 months. In particular, unemployed people covered by the statutory unemployment insurance scheme stood a better chance of finding a job. At the same time, the transition rate from employment to unemployment remained close to its lowest level of the past 30 years, which was reached in 2022. The probability of dismissal is thus still very low. The IAB survey on unemployment is no longer quite as deep in negative territory. The number of unemployed persons is therefore likely to stabilise in the coming months.

Wages and prices

Weaker rise in negotiated wages in Q4, …

In the fourth quarter of 2023, negotiated wages temporarily rose less sharply than in the third quarter. Including additional benefits, they were up by 3.6% on the year in the fourth quarter, compared with 4.7% in the quarter before. As in the first three quarters of 2023, large tax and social contribution-exempt inflation compensation bonuses played a key role. Factoring out these one-off payments, negotiated wages rose by 2.5% year on year in the fourth quarter, a distinctly slower increase than the 2.9% recorded in the third quarter.[4] How-

4 The higher increase in the third quarter was mainly due to the high inflation compensation bonus of €1,240 for Federal civil servants, which was paid out in September 2023.

House prices in Germany in 2023

House prices fell significantly in 2023, primarily because credit-financed real estate was less affordable as a result of high inflation and the interest rate hikes from the second half of 2022 onwards. Monetary policy tightening also reduced demand for housing. This meant demand increasingly shifted to the rental market, and the already high inflation in rents saw a significant further acceleration. The faltering expansion of supply helped prevent prices from falling even further. Overvaluations came down as prices fell in 2023. As a result, there is currently less downside potential than in previous years. However, as overvaluations are not yet fully eliminated, further corrections cannot be ruled out.[1]

According to data from the Association of German Pfandbrief Banks (vdp), the prices of owner-occupied housing fell by 4.1%. Averaged over the first three quarters of 2023, the Federal Statistical Office's price index fell much more sharply compared with the same period of the previous year, namely by 8.9%. Hypoport AG's EPX price index for residential real estate declined by 4.2% in 2023. All three indicators show a considerable decline in house prices.

According to calculations based on price data provided by bulwiengesa AG, house prices in the 127 German towns and cities fell by 4.5% last year, after having risen significantly by 6% in the previous year. In the seven major cities, the decline came to 5%.[2] The quarterly vdp data paint a similar picture, with house prices in the seven major cities falling by 5.3% in 2023 according to this measure. Comparing the vdp data for major cities with those for Germany as a whole confirms the impression gleaned from the previous upswing in prices – that the prices of residential real estate tend to move more quickly in metropolitan than in rural areas. Since the turning point in 2022, prices in towns and cities have come down more than in less populated districts. However, price measurement is currently subject to particularly high uncertainty. In particular, the importance of properties' energy efficiency in determining prices may have increased. The price changes reported may also reflect higher markdowns for properties with low energy efficiency.[3]

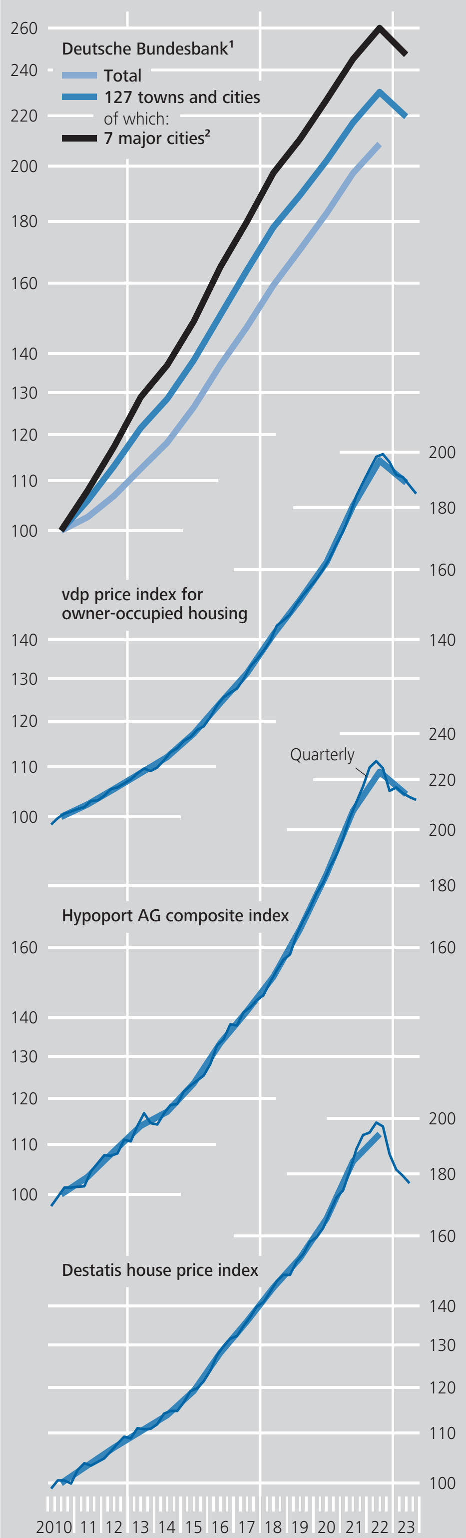
Unlike purchase prices, rents rose last year, with growth significantly stronger than in 2022. According to vdp, the year-on-year rise in rents for new lettings in multi-family dwellings was 6.3%. This equates to a further acceleration in rental inflation as compared with previous years. According to calculations based on data provided by bulwiengesa AG, rents for new lettings rose by 5.5% in towns and cities. Rents in the seven major cities went up by almost 7%.

During 2023, much tighter financing conditions and the only gradual decline in inflation from a very high level weighed on the propensity to acquire residential real estate. However, after adjustment for inflation, households' disposable incomes recovered over the course of the year. Population growth, which was buoyed by immigration,

1 This box deals with the ramifications of house price developments for the real economy. To assess them from a financial stability perspective, it is also necessary to consider aspects relating to housing loans.
2 The seven major cities are Berlin, Cologne, Düsseldorf, Frankfurt am Main, Hamburg, Munich and Stuttgart.
3 See Deutsche Bundesbank (2023a). This is the case, amongst other things, if the influence of properties' energy efficiency feeds into the index in a time-invariant manner.

Price indices for housing

2010 = 100, annual data, log scale



1 Weighted by transaction. Bundesbank calculations based on price data provided by bulwiengesa AG. **2** Berlin, Cologne, Düsseldorf, Frankfurt am Main, Hamburg, Munich and Stuttgart.

Deutsche Bundesbank

also helped prevent a stronger dampening of demand. Moreover, interest rates on loans for house purchase, although significantly higher, were no higher in the reporting year than in 2009 after adjustment for long-term inflation expectations. The dampening of demand caused by monetary policy did contribute quite strongly to the decline in house prices. However – given that demand came down from a very high level – the reduced affordability of loan-financed residential property was a more decisive factor in bringing down prices. This is also likely to be one reason for the large increase in rental prices for new lets. Many potential buyers were probably forced to rent rather than buy, at least for the time being.

Supply grew even more slowly in 2023. The cost of construction materials rose sharply following very high growth in 2022, in part due to ongoing supply bottlenecks and shortages of building materials. In addition, wage costs in the construction sector increased. Moreover, tighter financing conditions hampered growth in supply. The number of completed housing units, which had stood at 295,000 in previous years, is likely to have declined in 2023 due to the exceptionally large number of cancellations.[4] The number of building permits is also likely to have decreased sharply in 2023, to around 270,000.

Overvaluations in towns and cities declined significantly in 2023.[5] Estimations show that residential property prices in towns and cities were between 15% and 20% above the level that socio-demographic and economic fundamentals would suggest is ap-

4 See ifo Institute (2023).
5 This development had already started to emerge during the course of 2023. See Deutsche Bundesbank (2023a).

propriate.[6] The decline was especially marked in the seven major cities. The price-rent ratio for housing units in towns and cities exceeded its longer-term average by around 20%. The aggregate price-income ratio was just over 20% above the reference value in 2023. The long-term relationship between real estate prices, interest rates and incomes indicates overvaluations ranging from 10% to 15%.[7] Overall, overvaluations, though considerably reduced, are unlikely to have been brought down to zero. This means that there is still a certain risk of price corrections.

6 For details on the underlying panel estimation approach, see Deutsche Bundesbank (2020a).
7 For more details on the valuation approaches, see Deutsche Bundesbank (2020b).

ever, this cannot be taken to imply a turnaround towards lower negotiated wage increases in the future, because the wage agreements recently negotiated include zero months with no wage rises at the beginning of their terms. Subsequently, inflation compensation bonuses will be paid out with a time lag.[5] There will then be significant, permanent wage increases from the fourth quarter of 2024. All in all, the pay round settlements for 2024 and 2025 envisage robust negotiated wage increases.

… but continued strong growth in actual earnings

The sharp growth in actual earnings in the previous ten quarters continued and is likely to have once again significantly outstripped the increase in negotiated wages in the fourth quarter of 2023. This is also indicated by the sharply higher nominal wage data available through to December 2023 from the Federal Statistical Office's earnings survey. According to interim figures calculated on the basis of data from the national accounts, growth in actual earnings amounted to 6.1% in 2023, the highest rate since 1992.

Latest collective wage agreements deliver strong increases; still no deal struck for trade

The latest collective pay agreements delivered particularly strong wage increases. In annualised terms, wages rose by 5.9% in the public sector of the Federal states, 4.8% in the steel industry and 4.0% in the wood and plastics processing industry.[6] In the retail sector, as well as in wholesale and foreign trade, no new agreement has been reached in the negotiations that have been dragging on since April 2023. This dampened the rise in the 2023 ne-

5 In the case of the negotiated pay rises to be registered in the first few months of 2024, it matters when the inflation compensation bonuses are recorded in the statistics. For example, the inflation compensation bonus of €1,800 agreed in mid-December 2023 in the public sector of the Federal states will not be paid out to wage earners until the first quarter of 2024 owing to official regulations.
6 For someone earning the agreed basic pay rate. Owing to base amounts and inflation compensation bonuses, the increase can be higher in lower pay grades and lower in higher ones. In the wood and plastics processing industry, the rise varies slightly depending on the region.

gotiated wage index for the macroeconomy owing to the large number of zero months. Future sector agreements could significantly raise wage growth rates in 2024.

Major pay round for just under 60% of salaried staff

The first few months of this year's pay round for roughly 13 million wage earners (just under 60% of salaried staff) will mainly see negotiations in some services sectors and in the main construction sector. Attention switches to major industrial sectors such as the chemical industry as of May, followed by the metal industry from summer onwards. Trade unions are still demanding very high wage hikes, with past real wage losses likely to be a factor in their demands: an increase of 12% over a 12-month term in the printing sector, a rise of 8.5% over a 12-month term in temporary agency employment, and a permanent monthly wage increase of €500 (around +13%) in the main construction sector. IG BCE, the trade union for mining, chemicals and energy, is recommending wage demands of +6% to +7% for negotiations in the chemical industry. It should be noted, however, that the latest collective wage agreement reached in the chemical industry has already exhausted the legal scope for inflation compensation bonuses exempt from tax and social security contributions (limited to €3,000).[7]

High wage pressures expected in 2024 as well

Trade union demands for lasting improvements to real wages combined with widespread labour shortages suggest that prospective new pay deals will be high. By contrast, weak economic activity and the likely further easing of inflation could put something of a damper on the new pay increases being negotiated. Trade unions' willingness to strike is likely to remain high given the real wage losses that have arisen over the past three years and have not yet been fully compensated for. Unions have achieved a higher percentage of their demands since 2022 than in the previous 15 years. In the pay round settlements for 2023, and those on record for 2024, increases in real wages often only came about thanks to the high inflation compensation bonuses. As calls are still being made for improvements to real wages, higher permanent negotiated pay increases might be agreed after the end of the year, which is when these special bonuses will expire. According to the aggregate profit margin indicator, profit margins in the third quarter of 2023 – quarterly data are available up to this point – rose only marginally on the year in seasonally adjusted terms.[8] Profit margins widened in the manufacturing sector and narrowed in the services sectors. Aggregate profit margins increased by 3% compared with the first quarter of 2021. There were significant differences between the sectors. Profit margins rose by just under 3% in manufacturing (excluding construction) and by around 30% in construction, but they were up by only 1% in the services sectors. The latter sectors are therefore likely to have built up less scope than in manufacturing to cushion the intense wage cost pressures observed recently in some cases.

Minimum wage increase to €12.41 with small aggregate wage effects

Effective from January 2024, the general statutory minimum wage rose from €12 to €12.41 per hour, a hike of 3.4%. This increase is having no significant impact on average wages in the economy as a whole, as it mainly affects lower wage brackets in low-paid jobs with very few spill-over effects on higher pay grades.

Disinflation process continued in Q4 2023

For the first time since the end of 2020, consumer price inflation (HICP) was only marginal in the fourth quarter of 2023. On average across the months of October to December 2023, consumer prices increased by only a seasonally adjusted 0.2%, compared with a rise of 0.7% in the previous quarter. This was mainly

7 The pay deal concluded in the chemical industry in mid-October 2022 was the first in a major sector to feature an inflation compensation bonus exempt from tax and social security contributions. As this deal exhausted the legal scope for inflation compensation bonuses, the next pay deal will no longer contain that component. Along with a reference to securing real wages in the long term, the high wage demands are backed up by an internal survey conducted by the IG BCE trade union, which finds that three out of four salaried employees in the chemical industry are having to make cuts to their household budgets. Furthermore, 55% of them said that their personal economic situation is currently worse than it was one year ago.
8 The profit margin indicator corresponds to the ratio of the gross value added deflator to unit labour costs.

Recent inflation developments in the light of a stylised macro model

In the fourth quarter of 2022, the inflation rate in Germany and the euro area reached all-time highs in excess of 10%. Although inflation rates have gone back down considerably since then, they are still just shy of 3%. In the academic and economic policy debate, a wide variety of possible explanations have been ventured as to what caused inflation to rise following the subsiding of the COVID-19 pandemic. Reference is made, amongst other things, to supply bottlenecks and commodity price shocks, but also to domestic factors such as excessively accommodative monetary and fiscal policy in response to the COVID-19 pandemic.[1,2]

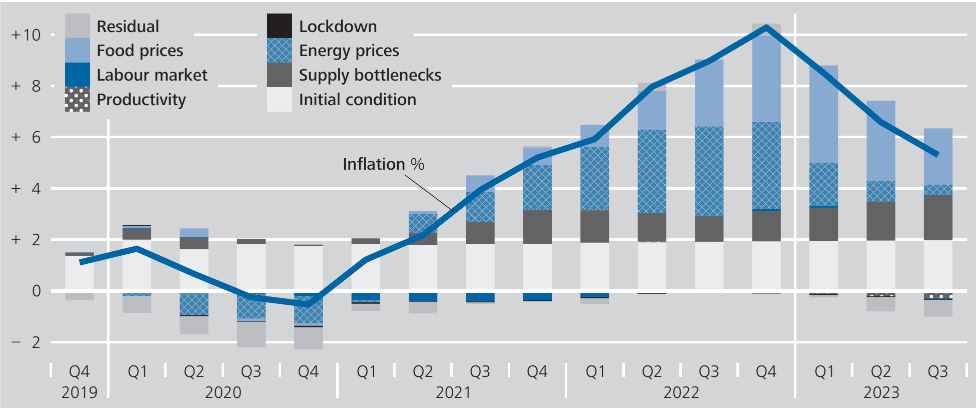
A broadly acclaimed contribution to the debate on the triggers and determinants of the high inflation was made by Bernanke and Blanchard (2023), initially for the United States. For their research, they used a small stylised macroeconomic model of a closed economy, consisting of a price equation, a wage equation and an equation each for short-run and long-run inflation expectations. At the core of the model are the interactions of inflation, wages and expectations. The impacts of exogenous shocks can thereby be amplified. The authors find, in their estimates for the United States, that commodity price shocks and supply bottlenecks triggered the rise in the inflation rate. Tight labour markets, through higher wage agreements, only contributed later, though with greater persistence, to price increases.[3]

The Bernanke-Blanchard model was applied to various euro area countries, Japan, the United Kingdom and Canada as part of an international working group. In this context, the Bundesbank applied the model to Germany and the euro area (see Menz (2024)).[4] As in the United States, the rise in inflation rates in the euro area is likewise attributable to energy and food price shocks and supply bottlenecks. The triggers for these shocks are not explained in the model itself. However, it stands to reason that supply and demand factors made a contribution. Granted, the high labour market utilisation, which was due in part to supply and demand factors, led to high wage rises in the euro area, too. However, the price-driving effects this unleashed, according to the model, have thus far been somewhat weaker than in the United States. Owing to the interaction between prices, wages and inflation expectations baked into the model, the estimated impact of wages on prices contains second-round effects.[5] Moreover, the model does not provide any evidence that the surprisingly high inflation rates in the past were reflected in additional wage demands to such an extent as to have led to an explosive wage-price spiral. To be sure, short-run inflation expectations responded to energy price shocks and current price surges, which also amplified wage

1 Greater attention was also given to claims of "greedflation", according to which firms took advantage of their market power and the particular circumstances of the post-pandemic era to raise their prices more strongly than would have been necessitated by cost pressures. However, there has so far been virtually no empirical evidence in support of this allegation.
2 For details and references to academic and economic policy studies, see Menz (2024).
3 For a comparison of inflation developments in the United States and the euro area, see also Deutsche Bundesbank (2022).
4 The model is estimated econometrically as a structural VAR, which is extended to a panel approach for the euro area, incorporating country-specific effects.
5 The transmission of wage growth to prices has not changed significantly in connection with the high inflation rates of recent years. In Germany, it still stands at just over one-third. See e.g. Deutsche Bundesbank (2019c) and Bobeica et al. (2019).

Model-based decomposition of the inflation rate in Germany*

Percentage points



* Inflation rate calculated as the log annual change in the seasonally adjusted HICP.
Deutsche Bundesbank

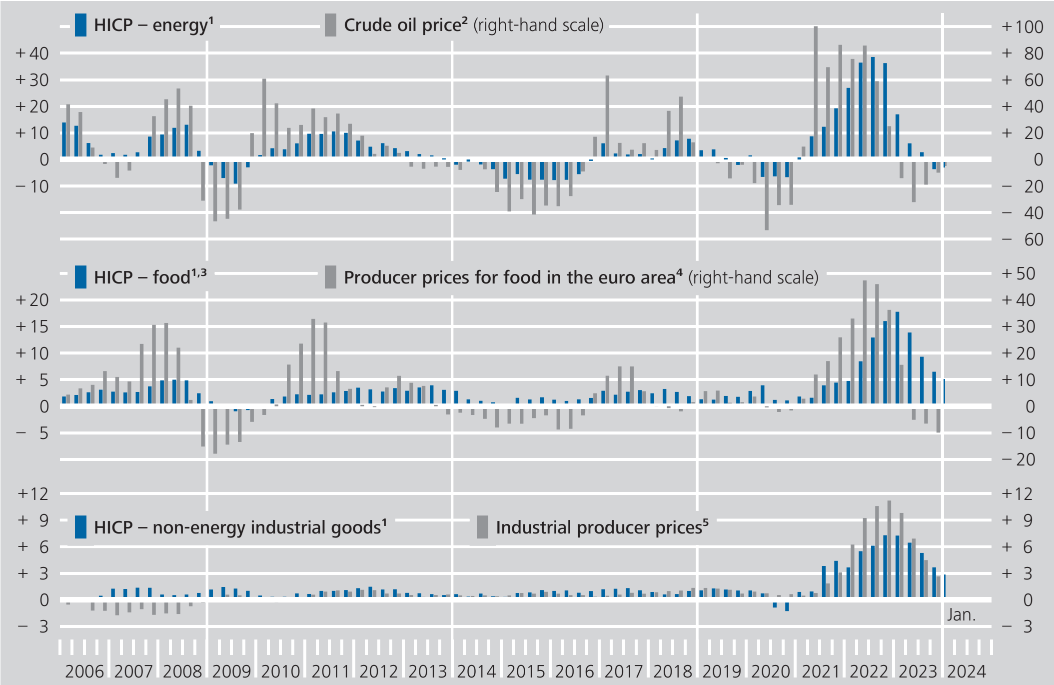
growth. However, short-run inflation expectations remained highly correlated with long-run inflation expectations. This anchoring of inflation expectations has had a stabilising effect overall.

The model can be used not only to analyse the recent past but also to derive possible scenarios for movements in prices, wages and inflation expectations in the near future. Assuming that labour markets gradually ease and no new shocks occur in the commodity markets, the model assumes that inflation will gradually decline in the near future. The results for Germany are broadly in line with the Bundesbank's inflation forecast from December of last year, according to which the inflation rate in Germany will not return to levels of just over 2% until sometime during 2026 (see Deutsche Bundesbank (2023b)). By contrast, in the current model scenarios for the euro area, inflation returns more rapidly towards the 2% mark than forecast by the Eurosystem in December (see European Central Bank (2023)).

By focusing on the interactions of prices, wages and expectations, the Bernanke-Blanchard model, on the one hand, makes an important contribution to the analyses of these key macroeconomic variables. On the other hand, it disregards a number of price-driving factors such as monetary policy, taxes and other fiscal measures, but also specific information on individual markets (such as weather effects or sector-specific price-setting behaviour). However, these can be of crucial importance for a good forecast. In this sense, the scenarios of falling inflation rates should be understood as evidence in support of the downward-sloping but more detailed forecast paths in the Eurosystem's projections. A precondition for the disinflation process to be expected according to the Bernanke-Blanchard model actually occurring in the euro area is that the commodity markets are not hit by any new price shocks and that the labour market tightness is overcome. Given the persistence of geopolitical uncertainties, further commodity price shocks, in particular, cannot be ruled out. The Bernanke and Blanchard model also suggests that, should such price-driving influences continue for longer, a timely return in the direction of the 2% mark will become more difficult.

Price developments at economic stages as classified for HICP purposes

Year-on-year percentage change



1 Eurostat. **2** Bundesbank calculations (in euro) based on daily prices in USD as quoted by Bloomberg Finance L.P. **3** Including beverages and tobacco products. **4** ECB calculations of DG AGRI prices based on the European Commission's farm-gate and wholesale market prices. **5** Analogous to HICP classification "non-energy industrial goods"; Bundesbank calculations based on data from the Federal Statistical Office.

Deutsche Bundesbank

due to the sharp fall in energy prices. Moreover, prices for industrial goods excluding energy and services did not go up quite as strongly as in previous quarters. Food prices, meanwhile, rose at more or less the same rate as in the third quarter. The process of disinflation in the fourth quarter was evident in year-on-year terms as well, with the headline inflation rate falling significantly to 3.0% from a level of 5.7% in the same quarter of the previous year. The sharp rise in energy prices in the final quarter of 2022 had a dampening effect here, but the core inflation rate (HICP excluding energy and food) also dropped steeply, falling from 5.8% to 3.6%.

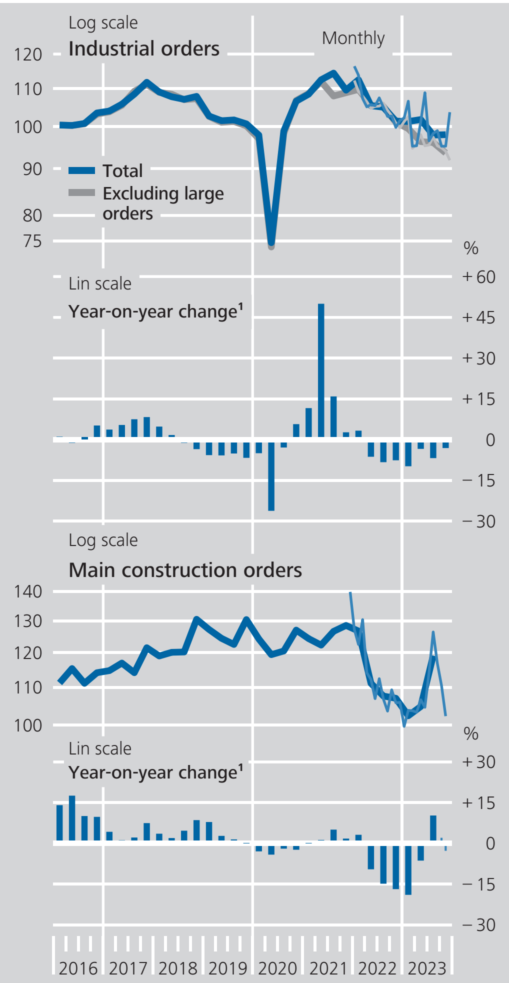
Inflation fell somewhat further in January; core rate unchanged

The HICP rate dropped markedly in January as well, from 3.8% to 3.1%.[9] This was mainly due to the elimination of the base effect from the 2022 price-lowering Emergency Aid for Natural Gas Heating for End Consumers *(Erdgas-Wärme-Soforthilfe)*, which had temporarily significantly increased the December rate. Food and non-energy industrial goods inflation likewise eased considerably. By contrast, services saw strong price increases at the beginning of the year, especially in areas where prices are not administered. Rents went up at a faster pace and numerous insurance premiums became more expensive. In addition, prices in restaurants and cafés recorded an extraordinary surge. One factor at play here was the expiry of the temporary VAT cut for meals eaten in catering establishments, even though the tax increase was probably not passed through fully into consumer prices. Lastly, the national carbon price charged on fossil fuels went up. On balance, the core rate remained at 3.4% in January.

9 The national CPI rate stood at 2.9%, down from 3.7%. In the case of the HICP, the January figures are also based on the routinely updated weights for 2024. Here, there were no major changes in consumer spending – compared with previous adjustments made over the pandemic period.

Demand for industrial goods and construction services

Volumes, 2015 = 100, seasonally and calendar adjusted, quarterly data



Source of unadjusted figures: Federal Statistical Office. **1** Only calendar adjusted.
Deutsche Bundesbank

Disinflation process expected to slow down

The inflation rate will probably generally decline further in the next few months. In some cases, strong fluctuations in the year-on-year rate are to be expected. This is due to some base effects in energy and local public transport. Moreover, Easter falls earlier this year than last, which is relevant for package holiday prices. The main factor behind the disinflation process is the declining price dynamics in food and industrial goods. Here, weakening inflation has an impact on upstream stages. By contrast, price pressures in the services sector are likely to ease much more slowly in the coming months, partly because wage growth remains strong.

Order books and outlook

Economic output could contract again in Q1 2024

Some headwinds will probably persist into the first quarter of 2024. Foreign industrial demand tended to decline significantly of late as well. Consumers are likely to remain cautious in their spending. Higher funding costs may continue to constrain investment. Additionally, uncertainty regarding climate and transformation policy remains elevated. Disruptions to production resulting from various strikes – including the rail and aviation strikes – cannot be ruled out, either. There are still orders on hand in industry and construction. However, they are dwindling. Economic output is thus likely to once again contract slightly in the first quarter of 2024. This second consecutive decline in economic output would put the German economy in a technical recession. While this would mean the ongoing period of weakness in the German economy following the start of the Russian war of aggression against Ukraine would continue, there is still no evidence of a recession in the sense of a persistent, broad-based and distinct drop in economic output and no such recession is expected, either.[10] In particular, the income situation and thus household consumption are likely to continue to improve in the future given the stable labour market, sharply rising wages and the declining inflation rate.

Industrial activity still weak at beginning of year

Industry is still navigating choppy waters at the beginning of the year. Demand for industrial products remained weak. December saw a sharp rise in industrial new orders on the month in seasonally adjusted terms, but this increase was attributable to large orders. Excluding this volatile component, new orders remained in significant decline. On an average for the fourth quarter of 2023, incoming orders levelled off close to the level of the previous quarter. Excluding large orders, both domestic and foreign demand for industrial products fell substantially. According to Federal Statistical Office data available up to November, the order books

10 See Deutsche Bundesbank (2019a and 2019b).

were still relatively well-filled. However, they have already shrunk considerably compared with the previous year. Short-term export expectations, along with production plans that deteriorated in January according to surveys by the ifo Institute, also suggest that industrial activity will remain weak.

Private consumption probably still sluggish

Consumers are likely to have significantly greater spending scope in the current quarter. Nevertheless, they are probably still holding back on their spending. The GfK consumer climate indicator deteriorated markedly again, with both the propensity to purchase and income and economic expectations declining. At the same time, the propensity to save increased significantly. Despite substantial growth in real incomes, private consumption is therefore likely to remain relatively sluggish in the first quarter. January's sharp drop in private car registrations, according to data from the German Association of the Automotive Industry, is one of a number of factors supporting this view. Surveys by the ifo Institute show that business conditions in the consumer-related retail and accommodation and food services sectors likewise deteriorated.

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